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What You Need To Know About Pension Changes

New Law and Court Ruling Mean More Companies May Convert Plans to 'Cash Balance' Model

By ELLEN E. SCHULTZ and THEO FRANCIS
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If you're covered by a traditional pension plan, the odds that your employer will change to a "cash balance" pension plan have just increased.

These new-style pensions, which currently cover roughly a quarter of the 22 million private-sector workers with pensions, have been controversial because switching to them reduces pensions for older workers -- sometimes significantly. This has led to lawsuits and proposed legislation to slow their spread, causing some employers to hesitate about changing.

But last week, a federal appeals court ruled that **International Business Machines Corp.**'s cash-balance pension didn't violate age-discrimination laws. Just days before that, Congress approved a measure that would deem cash-balance plans legal. While the ruling will be appealed, and the bill has yet to be signed into law by President Bush, employer groups say the recent actions are a green light for employers to change their pensions.

For employers, switching to a cash-balance pension plan reduces future payouts and boosts earnings. That, in turn, can result in big gains in executive incentive pay, which is tied to earnings.

CONVERSION CANDIDATES

Some employers are more likely to convert their traditional pension to a cash-balance plan:


- Companies with a large, older work force, such as utilities and manufacturers.
- Companies with many salaried employees.
- Companies with a well-funded pension plan.

Researchers at Cornell University, the University of Colorado at Boulder and the University of California at Irvine examined hundreds of companies that converted their pensions to a cash-balance formula, and they found that the average incentive compensation for the chief executive officers jumped to about four times salary in the year of the pension cut, from about three times salary the year before. Companies that didn't change their pensions saw little change, says Julia

D'Souza, a Cornell associate professor of accounting and lead author of the study, which is currently under review by an accounting journal.

For example, filings show that when **Cooper Tire & Rubber Co.** converted its pension to a cash-balance plan in 2002, the CEO's incentive pay rose to \$1.5 million -- the highest level in a decade -- from \$702,000 the year before. After a similar move by **Clorox Co.** in 1996, the incentive compensation for G.

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Craig Sullivan, its chief executive, jumped to \$5.6 million from \$961,000 the year before.

A spokesman for Cooper Tire called any correlation between its CEO's pay and its pension changes "completely coincidental." Clorox didn't respond to requests for comment.

The bottom line is that companies can boost their profits by converting to cash-balance plans and now face little legal risk in doing so. Unless you have already retired -- in which case your pension won't change -- here's what it may mean for you:

What is a cash-balance plan?

Cash-balance plans are pensions in which you have a hypothetical account that grows by an annual credit, say 3% of your pay each year, plus interest. When you leave your job, you usually can roll the amount into an individual retirement account or cash it out. If you're joining a company with a cash-balance plan, the mechanics are simple. But if you're at a company that switches from a traditional pension, things can get complex.

What happens to my pension when it's changed to a cash-balance pension?

Most traditional pensions are designed so that if you work a full career at a company, the pension will replace about a quarter of your final pay when you retire. While formulas vary, a plan might give you an annual benefit starting at age 65 equal to 1.5% of pay for each year of service. So, if you've worked 20 years at the company, and your average salary was \$50,000, that's a pension of \$15,000 a year ($.015 \times \$50,000 \times 20$).

When your employer converts to a cash-balance formula, the first thing it does is "freeze" the pension you've earned under the old formula. (This means it doesn't grow any more.) Your employer then calculates what this frozen pension would be worth if it were paid out in a lump sum of cash. This frozen pension value becomes the "opening account balance," which will grow with future contributions and interest.

Note that a cash-balance account is only virtual, or hypothetical. The pension plan hasn't changed -- it's the same pool of money, which your employer funds and manages. A cash-balance "plan" is simply the same old pension plan, with a new formula for determining your benefit.

How can a cash-balance plan reduce my pension?

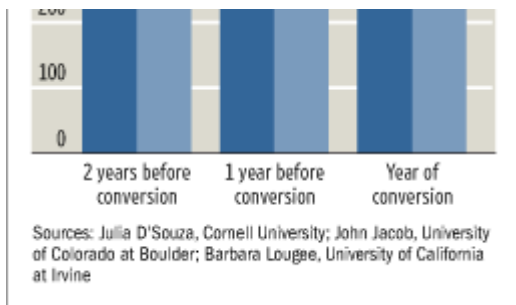
Because traditional pension benefits build up fastest in the later years, as much as half of a person's pension may be earned in the final five years on the job. When this older formula is frozen and the employee's pension grows only with the annual "interest" credits, the pension in retirement can be 20% to 40% lower than if the prior formula had remained in place.

Your pension could be reduced even further. Some companies lowball the opening account balances, giving someone an "account" worth, say, \$100,000, even if the frozen pension is worth \$120,000. As a result, you'd have to wait until your annual pay credits and interest build your "account" back up to \$120,000 before you begin building any additional pension.

This is one reason older employees complain of age discrimination; however, the bill Congress passed would ban some of the more-controversial practices.

Incentive Play

Firms converting to cash-balance pensions saw average incentive pay for chief executives jump



Why do employers change to cash-balance plans?

Companies can save money and boost profits. If a company has a pension surplus (most that converted in the 1990s did, and some that are converting today do), it can use the surplus assets to "fund" the contributions to workers -- offering the company a cash savings for a 401(k)-like benefit that it wouldn't have if it actually switched to a 401(k).

What's more, changing to a cash-balance plan reduces pensions, and thus a company's pension obligation. Under accounting rules, companies calculate how much they expect to pay out in pensions over the lives of their employees -- including amounts workers haven't earned yet -- and then reflect that amount as a liability on their books. When the pensions are cut, the estimated amounts that will no longer be paid out instead get added to income.

What kinds of companies change to cash-balance formulas?

Companies with work forces closer to retirement were more likely to change from traditional pension to cash-balance formulas, Ms. D'Souza found.

If you're a salaried worker, your pension is more likely to be changed. If you're covered by a collectively bargained contract, your employer typically must negotiate with your union before changing to a cash balance plan.

Since the early 1990s, roughly 400 companies -- commonly utilities, defense contractors and manufacturers -- that together have at least 1,200 pension plans have shifted to the new-style pensions.

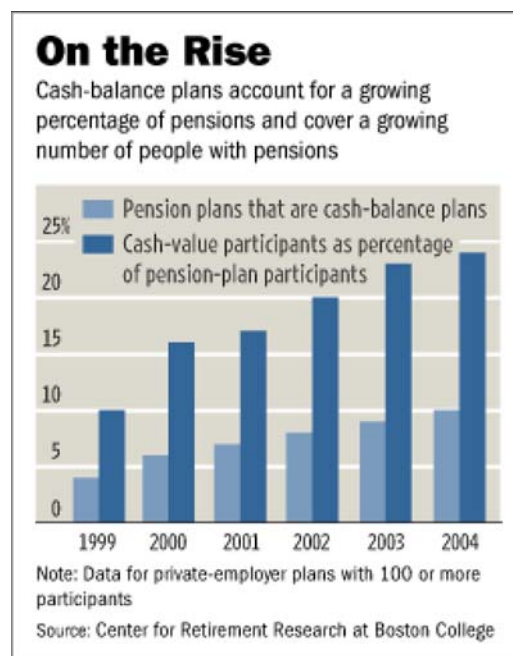
Are cash-balance plans better for younger workers and job-hoppers?

Employers say cash-balance pension plans are better for younger and more mobile workers because these workers can build up a better benefit than under traditional pensions, and take it with them when they leave. But last year, the Government Accountability Office concluded that most workers -- regardless of age -- get lower retirement benefits when employers switch from traditional pension plans to cash-balance plans.

What's more, workers get nothing if they leave before they are "vested," which usually takes five years. The GAO says more than one-third of workers in both traditional and cash-balance plans fail to vest, making cash-balance plans no better for job-hoppers than traditional pensions. (And most companies automatically cash out pensions with values below \$5,000, effectively already giving young mobile workers pension portability.)

What steps can I take if my pension is converted?

About half of employers making the switch provide a transition period to protect older workers, such as letting them stay under the prior formula for five years.



But some older workers choose the cash-balance option, because they like the idea of walking away with a lump sum. This is almost always a bad deal. Lump sums are often worth less than what you could get with a monthly pension at retirement age -- especially if you're in your late 40s to late 50s and have been at the company for many years.

Before deciding, ask to see the value of your pension in all possible forms: not just the cash-balance account, but the pension you'd get at age 65 if you chose to remain in the old plan, and that value converted to a lump sum.

Remember, your employer can still cut a cash-balance pension. In coming years, it can reduce the annual pay credit, or even freeze the plan. (**Sears Holdings Corp.** and **Verizon Communications Inc.** froze their cash-balance plans this year, and IBM announced it will freeze its plan at the end of 2007.) So you need to save as much as you can in a 401(k) account or elsewhere.

Cash-balance plans could be even riskier going forward, because the new pension law would allow companies to use an interest crediting rate that could turn negative, potentially wiping out all the interest credits previously earned.

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